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In the Supreme Court of the United States

OCTOBER TERM, 1942.

No. 40.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

THE OHIO LEATHER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

I. OPINIONS BELOW.

Neither the memorandum opinion of the United States Board of Tax Appeals, entered June 13, 1940 (R. 7-10), nor the decision of the Board entered under Rule 50 on July 3, 1940 (R. 16), are reported. The memorandum opinion of the Circuit Court of Appeals for the Sixth Circuit, entered December 9, 1941 (R. 19), is reported in 124 F. (2d) 397 (1941).

II. JURISDICTION.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

III. STATEMENT OF THE CASE.

A. The Proceedings Below.

This is a proceeding by the Commissioner of Internal Revenue (hereinafter referred to as the "Commissioner") to review a judgment of the United States Circuit Court of Appeals for the Sixth Circuit affirming an order of the United States Board of Tax Appeals overruling the Commissioner's determination disallowing a claimed credit of $20,949.36 against adjusted net income in computing the surtax upon undistributed profits of respondent, The Ohio Leather Company, (hereinafter referred to as the "taxpayer"), for the year 1936. An order allowing certiorari was entered by this Court April 6, 1942. (R. 20.)

The Board of Tax Appeals decided the case upon the authority of *Strong Manufacturing Company*, 41 B. T. A. 1273 (1940) and the United States Circuit Court of Appeals for the Sixth Circuit affirmed the Board of Tax Appeals in accordance with that Court's opinion in *Helvering, Commissioner v. Strong Manufacturing Company*, 124 F. (2d) 360 (1941).[1]

B. Question Presented.

There is no factual dispute between the parties herein. The tax involved was imposed by Section 14 (b) of the Revenue Act of 1936 upon "undistributed net income" which is defined in Section 14 (a) (2) as "the adjusted net income minus the sum of the dividends paid credit provided in Section 27 and the credit provided in Section 26 (c), relating to contracts restricting dividends." The issue presented calls for the application of a correct interpretation of the law to the provisions of a written contract relating to the disposition of profits of the taxable

[1] This case (No. 41) and that of Helvering, Commissioner v. Warren Tool Corporation (No. 42), involving substantially the same question as the case at bar are being heard by this Court in consecutive order.

year in discharge of a debt within the purview of Section 26 (c) (2) of that Act. The specific question presented is whether the taxpayer is entitled to a credit under the aforesaid Section upon its 1936 Federal Income Tax Return.

The Commissioner concedes the existence of a written contract executed by the taxpayer prior to May 1, 1936, and that it contains a provision expressly dealing with the disposition of earnings and profits of the taxable year to be applied in discharge of a debt. (Brief p. 14.) He challenges only the third requirement of Section 26 (c) (2) and contends that the taxpayer is not entitled to the credit because the contract does not contain any provision requiring that earnings of the taxable year be paid or irrevocably set aside within that year.

The taxpayer contends that it is entitled to the claimed credit because:

(1) The fixing within the contract of April 1 of the succeeding year for the delivery of the sums to discharge this liability was consistent with the provisions of Section 26 (c) (2) of the Act—a final determination of the amount due being physically impossible of ascertainment until after the close of the taxable year;

(2) The contract required it to irrevocably set aside within the taxable year a percentage of its earnings and profits[1] *for* the discharge of a debt which had accrued within the taxable year; and

(3) Upon consideration of its estimated net earnings within the taxable year and from the income of such year it irrevocably set aside *by actual payment* the amount now claimed as a credit.

---

[1] The Indenture uses the phrase "net earnings" (R. 7, 17) but under Treasury Regulations 94, promulgated under the Revenue Act of 1936, Art. 26-2 (c) (Appendix) such is considered the equivalent of "earnings and profits." The Commissioner does not contend otherwise.

C. Statutes and Regulations Involved.

The statutes and regulations involved will be found in the Appendix, *infra*.

D. Statement of Facts.

Substantially all of the facts have been stipulated (R. 16-18); certain facts appearing in the following statement and not a part of the stipulation have been found by the Board of Tax Appeals from the record. (R. 7-10.)[1]

As of January 1, 1936, the taxpayer corporation issued sinking fund debentures in the principal amount of $900,000.00 to mature in ten years pursuant to the terms of a certain Trust Indenture. (R. 8.) The sinking fund provision in the Indenture is in part as follows:

> "Section 1. The Company covenants that, to create a Sinking Fund for the further security of the Debentures issued hereunder, it will pay to the Trustee * * * on or before the next succeeding first day of April, * * * an amount equal to ten per cent (10%) of the net earnings earned by the Company during the fiscal year ending on the thirty-first day of the next preceding December, as such net earnings are defined hereinafter in this Article, which sums and amounts shall be held by the Trustee for the security of all outstanding Debentures until paid out as hereinafter provided. * * *
>
> "Section 2. On or before April 1, 1937, and thereafter annually on or before April 1st in each year to and including April 1, 1945, the Company will cause Ernst & Ernst of Cleveland, Ohio, or such other certified public accountant or accountants as may be approved by the Trustee hereunder, to determine the amount, if any, of the net earnings of the Company for the fiscal year ended the last preceding December 31st." (R. 7-8.)

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[1] All references hereinafter contained in this Statement of Facts are to the Memorandum Opinion of the Board of Tax Appeals found on pp. 7-10 of the Record unless otherwise indicated.

It was also provided that in lieu of the payment of cash into the sinking fund, the taxpayer could deliver to the trustee debentures which had previously been issued and subsequently reacquired by the taxpayer. (R. 8.)

Prior to December 14, 1936, the taxpayer estimated that ten per cent (10%) of its net earnings under the above quoted section of the Indenture for the taxable year 1936 would amount to $22,000, and at a meeting of its Board of Directors held December 14, 1936, the following resolution was unanimously adopted:

> "Whereas, the Indenture covering the Company's issue of Nine Hundred Thousand Dollars ($900,000) Ten Year 5% Convertible Sinking Fund Debentures, due January 1, 1946, dated January 1, 1936, makes mandatory the disposition of net earnings, and
>
> "Whereas, Section 26 (c) 2 of the Revenue Act of 1936 (defining credits permitted in connection with contracts restricting payments of dividends) required the payment or irrevocable setting aside within the taxable year, of the specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936; and
>
> "Whereas, information has been furnished to this Board of Directors that the ten per cent (10%) of the net earnings for the calendar year 1936 is Twenty-two Thousand Dollars ($22,000);
>
> "Now, therefore, be it resolved, that the officers of this Company be and are hereby authorized and instructed to specifically meet the requirements of said Indenture and Section 26 (c) 2 of the Revenue Act of 1936, and to irrevocably surrender to the Trustees, Debentures covered by said Indenture, with all unmatured coupons attached hereto, together with a certificate signed by the President or the Vice President, or the Treasurer of the Company, as to the price which the Company paid for such Debentures, and that such amount of Debentures to be irrevocably surrendered before December 31, 1936, shall have cost the Company not less than Twenty-two Thousand Dollars ($22,000)." (R. 17-18.)

During the year 1936 taxpayer had purchased out of its net earnings for 1936, from the holders thereof, and at a cost of not less than the principal amount thereof, debentures in excess of the principal amount of $47,000, and on December 16, 1936, deposited with the sinking fund trustee debentures with a face value of $47,000, pursuant to directorate authority contained in the above quoted resolution. Of this amount $25,000 was required under the Indenture to be paid on or before January 1, 1937, and the balance, $22,000, represented approximately 10% of the estimated net earnings of the taxpayer for the taxable year 1936. (R. 8.) The $47,000 principal amount of debentures so deposited with the trustee on December 16, 1936, were then cancelled and cremated. (R. 9.)

Subsequent to December 16, 1936, the taxpayer determined that its net earnings as defined by the Indenture for the calendar year ending December 31, 1936, were only $209,493.62 and that the credit to which it was entitled as against adjusted net income was only $20,949.36 as opposed to the $22,000 specified in the resolution of the Board of Directors of December 14, 1936. The taxpayer filed its income tax return on the accrual basis. (R. 9.)

The Commissioner refused to allow any part of such sum as a credit (Statement, R. 5) and upon petition of the taxpayer to the United States Board of Tax Appeals for a redetermination of an alleged deficiency in surtax the Board overruled the Commissioner's determination and allowed a credit of $20,949.36. (R. 9.) This order of the Board was subsequently affirmed by the Circuit Court of Appeals for the Sixth Circuit (Decree R. 19) and an order allowing certiorari having been entered by this Court the within proceedings are to review the judgment of the Circuit Court of Appeals.

IV. SUMMARY OF ARGUMENT.

The amendments to the legislation which subsequently became Section 26 (c) (2) of the Revenue Act of 1936, including other provisions of said Act, clearly manifest an intent on the part of Congress to allow a credit against adjusted net income where payment of an amount equal to a percentage of earnings and profits is postponed until after the end of the taxable year in order that the payment will include a portion or percentage of the profits of an entire year. It is a fundamental principle of statutory construction that the intention of the legislature is the most important guide and that it will be presumed that unfair and undue hardships are not intended; that in the case of taxing statutes imposing a burden of special or unusual character (as was the imposition of the surtax on undistributed profits[1]), where there is doubt or ambiguity in the terms of such a statute, every intendment is to be indulged against the taxing power and in favor of the taxpayer. Taxation is a practical matter and the substance of the thing done and not the form it takes must govern.

The covenant of the taxpayer to create a sinking fund for the security of the bonds issued under the contract by paying into such fund on or before April 1 of each year an amount equal to 10% of its net earnings for the preceding calendar year created an equitable lien upon such percentage of earnings when earned which was enforceable against such earnings for the benefit of the bondholders in the same manner as a lien upon specific things existing at the date of the contract. The taxpayer, by its contract, had assumed an obligation fiduciary in nature and subject to equitable cognizance and was under a duty to irrevocably set aside such percentage of earnings within the taxable year. It is one of the maxims of equity that "equity re-

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[1] This statute was repealed in 1939 after several amendments still proved that the theory of the original law was either impractical or obsolete. 3 Prentice-Hall, Fed. Tax Serv. (1942) 50,241.

gards as done that which ought to be done" and this covenant of the taxpayer was subject to enforcement by suit for specific performance. The contract thus constitutes an agreement to irrevocably set aside a percentage of earnings and profits within the taxable year and therefore to the extent that such constituted 10% of its net earnings the taxpayer is entitled to a credit under Section 26 (c) (2) of the Revenue Act of 1936 in determining its undistributed net income as defined in Section 14 (a) (2). The action of the Board of Directors of taxpayer on December 14, 1936, in authorizing its officers to meet the requirements of its contract by irrevocably surrendering within the taxable year the equivalent in bonds of the specified portion of its earnings for the taxable year, and their subsequent action in so doing, constituted a clear and unequivocal recognition by the taxpayer of the equitable lien so acquired by the debenture holders and constituted a compliance with the requirement of the contract that such amount be irrevocably set aside within the taxable year.

In interpreting the credit provisions of Section 26 (c) (2), the United States Board of Tax Appeals has consistently adhered to the principles early announced by it in the *Strong Manufacturing Company* case which was subsequently affirmed by the Circuit Court of Appeals for the Sixth Circuit. It is further suggested that there is no conflict of opinion or authority between the various Circuit Courts of Appeal nor error in the result reached by the Circuit Court of Appeals for the Sixth Circuit in the instant case.

V. ARGUMENT.

A. The amendments to the legislation which, when enacted, became Section 26 (c) (2) of the Revenue Act of 1936, including other provisions of said Act, show an intent on the part of Congress to allow a credit herein.

The Revenue Act of 1936, c. 690, 49 Stat. 1648, provided a new method of taxing corporations by imposing a surtax upon undistributed net income. Its purpose was clearly to force the distribution of profits into the hands of shareholders where they would be subject to an income tax.[1] As originally introduced in the House of Representatives (H. R. 12395, 80 Cong. Rec. 5978) it contained five schedules of tax rates—Sections 13 to 17, inclusive—providing for the relief of deficit, debt-laden and dividend restricting contract corporations. Such required the determination of earnings from the beginning of the corporate life and projected their application a minimum of five years into the future. (Sections 14 and 16 of Appendix B to Commissioner's Brief. See also Seidman's Legislative History of Federal Income Tax Laws, pp. 217-223.) Yet, when the matter was considered by the Senate Finance

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[1] As stated by the Committee on Ways and Means of the House of Representatives:

"The major purposes of the change in the method of taxing corporate incomes are (1) to prevent avoidance of surtax by individuals through the accumulation of income by corporations, (2) to remove serious inequities and inequalities, and (3) to remove the inequity as between large and small shareholders resulting from the present flat corporate rates. • • • Corporations should not be permitted to withhold from the beneficial shareholders unneeded corporate income at the expense of the revenues of the United States and to the detriment of the shareholder. The bill proposes to remove many of these inequities by relieving from tax corporations which distribute all their net earnings annually as earned, and by taxing corporations accumulating their net income at a rate to compensate to a large extent for the amount of tax on the shareholders' income lost by reason of the failure to make a complete distribution. • • •" (H. of Rep. Rept. No. 2475, 74th Congress, 2nd Sess. Cum. Bul. 1939-1 (part 2) 667, 669.)

Committee the House Bill was altered in major respects. That committee restored the old form of taxing corporate incomes and superimposed a surtax upon undistributed profits. It eliminated the back-earning history (Section 14) and the projection far into the future of the liquidation of debts (Section 16) by use of the language "*during* the taxable year." (Ibid. pp. 216-217.)

On the floor of the Senate the Bill was subject to more violent criticism than in the House (Paul and Mertens Law of Federal Income Taxation, 1939 Supp.; 1393-1396, Section 32 A. 03), the Finance Committee changes were again rewritten and present Section 26 (c) (2) was finally adopted as an amendment with the consent of the Senate Finance Committee.[1]

Section 26 (c) (2) as finally enacted contained two important features to which comment will now be directed, to-wit:

(1) The concluding sentence of this sub-section referring to an amount equal to a percentage of earnings and profits now appeared for the first time; and

(2) The phrase "within the taxable year" was used instead of "during the taxable year" as first appeared in the Senate Finance Committee draft:

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[1] "Mr. Couzens: Mr. President, this amendment was generally discussed in the committee; and in view of the language of the bill there were left out, in the judgment of the committee, other forms of debt than those dealing with the payment of dividends. The last words on line 22, page 53 [the proposed Section 26 (c) (1) which afforded a credit in the case of a contract which prohibited payment of dividends *during* the taxable year], seem to exclude obligations of the corporation to pay debts or withhold earnings for specific purposes under contract.

"I have consulted those on the committee, and so far as the committee is concerned, there seems to be no reason for not adopting the amendment." (80 Cong. Record, 9071.)

1. The incorporation in Section 26 (c) (2) of the provision that a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits.

The concluding sentence of Section 26 (c) (2) so added before enactment is as follows:

> "For the purpose of this paragraph, a requirement to pay or set aside an *amount equal to a percentage* of earnings and profits shall be considered a requirement to pay or set aside such *percentage* of earnings and profits." (Emphasis ours.)

It is submitted that this added provision is most significant in construing the intent of Congress as expressed in Section 26 (c) (2) of the Act. First Congress provided that a credit was obtainable by paying or setting aside a *portion* of the *entire year's* earnings and profits and then provided that a requirement to pay or set aside an *amount equal to a percentage* of such earnings and profits should be considered as a requirement to pay or set aside such *percentage* of earnings and profits. Such a declaration is most persuasive of the fact that Congress intended that Section 26 (c) (2) should be liberally construed and that under such a construction the allowance of a credit in the instant case is manifestly proper. If otherwise considered we pose the inquiry—how can an amount based on a percentage of earnings be determined until the year is ended and the books are closed? Accruals, last minute transactions, the time necessary to take and value inventories, the closing of books, the ascertainment of Federal taxes, the determination of earnings to which a percentage can be applied—all take time.[1] Until earnings, therefore, are determined, the amount to be set aside can not become fixed

[1] It is common knowledge that the ascertainment of the net earnings of manufacturing is impossible of determination until after the close of the taxable year. This fact is recognized by Article 22 (c)-1 of United States Treasury Regulations 94 (relating to the Revenue Act of 1936) wherein it is stated:

(Continued on next page)

and of necessity, the phrase "within the taxable year" must mean "within the taxable accounting year"; otherwise the percentage provision of the statute would be wholly ineffective except as to banks and trust companies which are, however, exempt from the undistributed profits tax.[1]

In the administration of income tax laws a common sense interpretation and ordinary everyday business standards should be followed. This principle has repeatedly been announced by this Court and the lower Federal Courts in the following language:

> "Taxation is a practical matter and those practical considerations which support the treatment * * * are the same. * * *." *Harrison v. Schaffner*, 312 U. S. 579; 85 L. Ed. 1055 (1941).
>
> "It has been too often said to warrant citation that taxation is an intensely practical matter and that the substance of the thing done and not the form it took, must govern. This principle has been repeatedly invoked by the Commissioner and applied by the Board. *Carter Publications, Inc. v. Commissioner*, 28 B. T. A. 160; *Warner Co. v. Commissioner*, 26 B. T. A. 1225; *George Whittell & Co., Inc. v. Commissioner*, 34 B. T. A. 1070."
>
> *Commissioner v. Ashland Oil & Refining Co.*, 99 F. (2d) 588 (C. C. A. 6, 1938). Certiorari denied 306 U. S. 661, 83 L. Ed. 1057, 59 S. C. 786.

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[1] It is to be noted that only banks and trust companies can accurately determine their net earnings as of the last day of the taxable year without taking inventory and are, therefore, the only taxpayers which could comply with Section 26 (c) (2) as interpreted herein by the Commissioner. Yet such institutions are wholly exempt from the surtax on undistributed profits. (c. 690, Title I, Section 104; 49 Stat. 1677.)

(Continued from preceding page)

"Art. 22 (c)-1 *Need of inventories.* In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. * * *"

To the same effect are:

Rhodes v. Commissioner, 100 F. (2d) 966 (C. C. A. 6, 1939);

Welch v. Helburn, 5 F. Supp. 581 (Dist. Ct. Ky. 1933).

2. The use in Section 26 (c) (2) of the phrase "within the taxable year."

We also consider as important and significant the fact that the Senate floor amendment as finally enacted changed the phrase "*during* the taxable year" (originally appearing in the Finance Committee draft) to the phrase "*within* the taxable year" in view of the interpretation given the latter phrase in decisions of the Courts and of the United States Board of Tax Appeals in the case of deductions for bad debts under Section 23 (k) of the Revenue Act of 1936. This latter section—as well as all preceding Revenue Acts as far back as 1918—provides that "debts ascertained to be worthless and charged off *within* the taxable year * * *" are deductible from gross income in arriving at net income. This statutory language has been construed almost without exception and without legislative change to allow a deduction for bad debts physically charged off in the first months of the succeeding year as of the preceding taxable year.

Thus, in *Mason Machine Works Co.*, 3 B. T. A. 745 (1926), acquiesced in by the Commissioner, the phrase "charged off within the taxable year" was interpreted, and the Board stated at page 750:

> "This language must be interpreted in the light of the ordinary course of business practice. It is not the physical act done within the year to which Congress has referred, but to the setting up of evidence of the ascertainment of worthlessness substantially as of the date of such ascertainment and in confirmation thereof."

In *George H. Fraser*, 6 B. T. A. 997 (1927), acquiesced in by the Commissioner, the Board again discussed this phrase, and stated at page 1002:

> "An interpretation of the statute which would deny any deduction except when a charge-off was made upon books of account within the limits of the calendar year, especially when it is considered that closing entries are not usually made until after the close of the year, would work a hardship which we cannot believe was intended or is required and would attach to acts which are merely clerical an importance as great as is to be given to the substance of the situation. The statute must be given a reasonable interpretation, if possible. * * *"

In *Chicago Ry. Equipment Co. v. Blair*, 20 F. (2d) 10, C. C. A. 7 (1927), the Court had before it a bad debt deduction under the Revenue Act of 1918, and stated at page 12:

> "* * * counsel places great stress upon the fact that he said that the entries were not made until January or February, 1919. The only other witness testifying on that point said: 'During the year 1918, we charged off something like $60,000; that is, at the expiration of 1918. * * *' We are of opinion that it was error to hold that they were not bad accounts and charged off *within the taxable year.*" (Emphasis ours.)

In *Jones v. Commissioner*, 38 F. (2d) 550 (C. C. A. 7, 1930), the Court again had the question before it under the Revenue Act of 1921, and stated at page 553:

> "The mere fact that the calculation for the income tax return was not made until some time between December 31, 1921 and March 15, 1922, ought not to be, and is not, controlling in determining when decedent ascertained and determined that the debt was worthless for the law does not require the calculation to be made *within the taxable year.*" (Emphasis ours.)

In the recent case of *Hamlen v. Welch*, 116 F. (2d) 413 (1940), decided by the First Circuit and involving the construction of Section 23 (k) of the Revenue Act of 1934, the Court at page 419 said:

> "We are also of the opinion that the debt was 'charged off within the taxable year' within the meaning of the statute. The statutory language has been construed many times without legislative change to allow a deduction for bad debts physically charged off in the first months of the succeeding year as of the preceding taxable year. [Citing cases.] The decisions of the Board of Tax Appeals have, in the majority of cases, been specifically acquiesced in by the Commissioner; and in the light of this circumstance and the frequent repassage of the identical language in subsequent revenue acts, we believe the interpretation of the statute to be well established to include the instant case.
>
> "Ordinary business practice necessitates the allowance of a reasonable time after the close of the year for the auditing of the books and the physical notation of the closing entries of profit and loss. It is not the physical act done within the year to which Congress has referred, but to the setting up of evidence as to the ascertainment of worthlessness substantially as of the date of such ascertainment and in confirmation thereof in order that such entries will effectually eliminate the amount of the bad debt from the book assets of the taxpayer, *Commissioner v. MacDonald Engineering Co.*, 7 Cir., 1939, 102 F. (2d) 942, 945; *Kentucky Rock Asphalt Co. v. Helburn, supra*; *Mason Machine Works Co., supra*; see III *Paul & Mertens, The Law of Federal Income Taxation* (1934), Sec. 28, 30. In the instant case the entries were made to profit and loss in January or February, 1936, as of December 31, 1935. This is enough to bring the case within the law as construed. *Cf. Coon Valley State Bank*, 1928, 13 B. T. A. 132; *Ed. C. Lasater*, 1925, 1 B. T. A. 956 (entries not made as of the taxable year)."

In *Kentucky Rock Asphalt Co. v. Helburn*, 20 F. Supp. 364 (Dist. Ct. Ky. 1937), (affirmed 108 F. (2d) 779, C. C. A.

6; 1940) the deduction was disallowed on other grounds, but the Court said at page 368:

> "As I have heretofore stated, the administration of the income tax revenue statute is concerned with practical things, and it is hardly feasible for the officers of a corporation to immediately determine at the close of the year deductible bad debts. While the language used in the act provides that the ascertained bad debts shall be 'charged off within the taxable year,' it is not to be presumed that the Congress intended this language to mean all entries on the books of a corporation should be made and the books closed at midnight of the day the taxable year ended. As a practical matter, many facts are assembled as a basis for the book entries after the close of the year and the Congress did not intend there should be an essential departure from the usual course of business in making book entries in order to comply with the income tax laws."

In the case at bar the payment was made during the taxable year, to-wit, December 16, 1936, although the exact amount to be determined by percentage was not required to be ascertained by Ernst & Ernst until April 1 of the succeeding year—or fifteen (15) days after the 1936 Federal income tax return was due. It is respectfully submitted that the determination and payment of the stated percentage of the net earnings of the taxpayer must be considered as being called for by the contract as of the taxable year and that the same complies with the requirements of Section 26 (c) (2). To hold otherwise would be to disregard the plain intent of Congress as expressed in the concluding sentence of that section to the effect that a requirement to pay or set aside an *amount equal to a percentage* of earnings shall be considered a requirement to pay or set aside such *percentage* of earnings.

3. The difference of language in the two grounds for credits under Section 26 (c) (2).

Attention is also called to the difference of language in the two grounds for credits under Section 26 (c) (2), viz., "* * * the portion of the earnings and profits * * * which is required * * * to be paid within the taxable year *in* discharge of a debt, or to be irrevocably set aside within the taxable year *for* the discharge of a debt. * * *"[1] (Emphasis ours.)

Clearly, the first ground for a credit contemplates that an actual payment must be required by contract to be made within the taxable year *in* the discharge of a debt. The second ground for a credit contemplates that the irrevocable setting aside must be effected within the taxable year in anticipation of or on account of a future payment. In other words, payment can be postponed until after the taxable year but the requirement is that the setting aside be effected within the taxable year. The use of the word "in" in the first instance denotes the discharge of a debt by the payment thereof in the present taxable year, while the use of the word "for" in the second instance is in the sense of futurity or time to come. The inclusion within Section 26 (c) (2) of the second ground for a credit shows that Congress contemplated situations like in the instant case where payment was postponed until after the close of the taxable year when a determination of the net earnings could be properly had and the required percentage of such earnings applied for the discharge of the debt. A percentage is a part of the whole and until the earnings for the whole or entire year are ascertained, a portion or percentage thereof remains an unknown quantity. Hence, the reason for the concluding sentence of Section 26 (c) (2).

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[1] This distinction is disregarded when referred to in the Commissioner's Brief, pp. 10, 13.

B. Section 43 of the Revenue Act of 1936 further clarifies the intent of Congress to the effect that Section 26 (c) (2) permits a percentage of earnings to be paid or accrued within the taxable year.

Section 43 of the Revenue Act of 1936, insofar as it applies to corporations, reads as follows:

> "The deductions and credits (other than the dividends paid credit provided in Section 27) provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *"

Sections 26 and 27 of the Revenue Act of 1936 are companion sections. They both relate to credits to corporations pertaining to dividends and are the two grounds for credit enumerated in Section 14 (a) (2) defining "undistributed net income." Still in Section 43 allowing credits for the taxable year in which such are *paid* or *accrued* Congress saw fit to exclude only Section 27. This parenthetical clause:

> "other than the dividends paid credit provided in Section 27)"

is new in the 1936 Act. The same language, *excluding* the parenthetical clause, appears in Section 43 of the Revenue Act of 1934. Congress, therefore, deliberately excluded only Section 27 from the time for taking credits, and this specific elimination of the Dividends Paid section clearly indicates the inclusion of the other section i.e. Contracts Restricting Payment of Dividends—as one where accrual is permitted. And since the taxpayer was on an accrual basis (R. 9) and also *paid* the estimated sinking fund requirements *within the taxable year* (R. 9, 18), it would appear that it was entitled to the claimed credit for 1936 on either method of accounting, cash or accrual.

There is good reason for the *inclusion* of Section 26 allowing an accrual of amounts paid or set aside within the taxable year to pay debts and the *exclusion* of Section 27 which disallows an accrual for dividends. As already stated the general purpose of the 1936 Act was to raise revenue by forcing corporations to distribute net earnings and if dividends could be accrued without payment to shareholders the professed purpose of the Act would be circumvented. The payment of a debt does not (apart from the slight possibility of capital gains) create taxable income for the holder of the obligation, whereas the payment of a dividend does in most instances result in an income tax.

There is also a further reason for this differentiation between Sections 26 and 27. In Section 27 the word "during" precedes the words "taxable year" four times and the word "within" does not appear at all; whereas, in Section 26 the word "within" precedes the words "taxable year" three times and the word "during" appears only in paragraphs (d) and (e) where the context clearly shows the necessity for the changed wording. Both Section 26 (c) (2) and Section 43 are within Title I of the Act, and since Section 27 is specifically excepted, it tends further to substantiate the contention of the taxpayer that Section 26 (c) (2) permits a percentage of earnings to be paid or accrued within the taxable year.

This Court has heretofore said in *United States v. Anderson*, 269 U. S. 422, 70 L. Ed. 347 (1926) that a Departmental regulation authorizing the use of the accrual method of accounting was adopted in order to enable taxpayers to keep books and make returns according to scientific accounting principles. The taxpayer adhered strictly to this principle. As will be hereinafter urged in this brief it was legally obligated to accrue 10% of its earnings for the taxable year in discharge of its indebtedness and it so computed the amount with reference to the probable earnings shown by its books and actually made payment within the taxable year of the amount so accrued.

It is not unusual for a corporation to make similar accruals for various purposes in closing its books. If it were not permitted to do so Section 26 (c) (2) would be practically voided by the interpretation placed thereon by the Commissioner because he must necessarily hold on the same theory that a payment made during the succeeding year related to the disposition of earnings of a *prior* year rather than of the taxable year during which payment was made. During the entire course of this controversy the Commissioner has never shown how Section 26 (c) (2) should be construed to give relief to a corporation required by contract to pay a percentage of its *entire year's* earnings if effect is to be given to the concluding sentence of that Section. Only now by his brief herein (Note 12, page 20) does he attempt any such suggestion but he still omits all reference to such concluding sentence. His suggestions, however, have little merit when we consider that all contracts in which the question may arise must of necessity have been executed prior to the enactment of the statute and hence have been drafted without thought of meeting in terms the statutory requirement because none then existed.[1] To suggest therefore that relief would be avail-

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[1] Thus in *Chess & Wymond, Inc. v. Glenn, Collector*, 40 F. Supp. 666 (Dist. Ct. Ky. 1941) the Court said on p. 670:

> "It will be noticed that the statute was enacted on June 22, 1936, which was more than six months after the agreement under consideration was entered into. If the statute had been in existence at the time of the negotiations between the plaintiff and the bank, it would have been comparatively easy to have executed a written contract complying in every respect with the provisions of the statute, and no doubt attention would have been given to precisely meeting those requirements. In such a case the formal contract should be strictly and literally construed. But the Court should consider the question from a much more liberal viewpoint when it analyzes a written agreement, informally entered into without intending to comply with any statutory requirements, because none existed, and without any thought or suggestion that it would be later tested for exact compliance with the provisions of a statute subsequently enacted and that it would be declared invalid if it did not meet that pattern in every detail."

able had the corporation contracted to pay upon the basis of quarterly statements or upon an approximation of net earnings would be shutting one's eyes to the plain facts and dealing with the question in an intellectual vacuum. Losses and unusual expenses incurred in a final quarter may very well exhaust earnings of the preceding quarters. Certainly Congress never intended the result urged by the Commissioner when it enacted Section 26 (c) (2) nor did it intend that the Commissioner should apply such a technical and unrealistic interpretation of this Section when such an obviously unfair consequence would be attained. As stated in *Morill v. Jones*, 106 U. S. 466, 27 L. Ed. 267 (1883), the authority given to the Secretary of the Treasury to make rules and regulations for the administration of the Revenue laws does not include the power to alter or amend such laws.

A regulation to be valid must be consistent with the statute and also reasonable. A regulation which "operates to create a rule out of harmony with the statute is a mere nullity." *Manhattan General Equipment Co. v. Commissioner*, 297 U. S. 129, 80 L. Ed. 528 (1936).

C. The contract required the taxpayer to "irrevocably set aside within the taxable year for the discharge of a debt" "an amount equal to ten per cent (10%) of the net earnings" for the discharge of a liability which had accrued within the taxable year.

It is the contention of the taxpayer that the covenant to pay to the Indenture Trustee on the next succeeding April 1, an amount equal to 10% of its net earnings for the taxable year constituted an agreement to "irrevocably set aside" such earnings "within the taxable year." By his action in refusing to allow the credit in question the Commissioner failed to recognize that the liability to set aside such an amount for the year 1936 had accrued although not ascertained as to exact amount until audit

was completed by April 1 of the succeeding year. Taxpayer was under a contractual duty to hold for the discharge of that liability a sum equal to 10% of its earnings—an obligation which the Trustee could have enforced in equity had taxpayer attempted to dispose of such sum and thereby threaten an impairment of the security to which the debenture holders were equitably entitled. Such percentage of income became impressed with a trust and a court of equity would clearly say that the postponing until April 1 of the date of payment was a matter of convenience only because the events necessary for the accrual of the liability had taken place by the end of the year and there remained only the ascertainment of the exact amount after an examination of the incidents of profit and loss. Only delivery of the sum was deferred by the terms of the contract until a proper audit could be completed but such audit could not change the actual result of the 1936 earnings of the taxpayer. It could merely verify those earnings and report the results shown by the books. The mere fact that upon final audit 10% of the actual earnings were shown to be only $20,949.36 instead of $22,000 as estimated by taxpayer on December 14, 1936, cannot change its obligation to accrue the amount of the debt within the taxable year.

The existence of an equitable lien in favor of bondholders and the right of the Trustee to restrain the disposal of corporate assets was recognized in *Marine Midland Trust Co. v. Allegheny Corporation*, 28 F. Supp. 680 (Dist. Ct. N. Y., 1939) where the Court found that the Corporation had covenanted to maintain collateral at 150% of the principal amount of the outstanding bonds and held that such was an obligation which the Trustee could properly seek to enforce in equity. Said the Court on page 683:

> "In fact any other construction would be unjust both to the bondholders who invested their money re-

lying on the representation and to those who officially executed the indenture in the honest belief that it was 'designed to carry out the intent of the corporation' as expressed in the representation. We are not to assume that they intended to do less than they had promised. They evidently intended to meet the terms of the offering circular. * * * Assuming that the defendant had covenanted to maintain the collateral at the 150% ratio, there are legal precedents for the enforcement of that covenant by suit for specific performance," citing *Greenleaf v. Blakeman*, 40 App. Div. 371, 58 N. Y. S. 76, affirmed *Greenleaf v. Schley*, 166 N. Y. 627, 60 N. E. 1111; *McNamara v. McNamara*, 256 App. Div. 370, 10 N. Y. S. 2d 94; *Hicks v. Turck*, 72 Mich. 311, 40 N. W. 339; *Pomeroy* Sec. 2175.

In *Morse v. Bay State Gas Co. of Delaware*, 91 Fed. 938 (Cir. C. Del., 1897) a demurrer had raised the question as to the right of the holders of income bonds to bring an action in equity and the Court in overruling the same said:

"But, again, it is contended that no duty was assumed with which a court of equity is competent to deal; that what is set up amounts to but a breach of contract. I can not assent to this. Those who took these bonds did not, as has been pointed out, accept mere promises to pay. They, of course, relied, and had a right to rely, upon the fidelity of the corporation for the production, protection, and application of net earnings, and by its necessarily implied undertaking to exercise good faith in this regard the corporation assumed an obligation which was fiduciary in its nature, and which, therefore, is of equitable cognizance."

In *Geddes v. Reeves Coal & Dock Co.*, 20 F. (2d) 48 (C. C. A. 8, 1927) the Court said at page 50:

"The general principles, rules and practice in equity applicable to this case have been stated by Pomeroy and his statement of them has been adopted and confirmed by repeated decisions of the Supreme Court and of others courts. He wrote: 'Every ex-

press executory agreement in writing, whereby the contracting party sufficiently indicates an intention to make some particular property, real or personal, or fund therein described or identified, a security for a debt or other obligation, or whereby the party promises to convey or assign or transfer the property as security, creates an equitable lien upon the property so indicated, which is enforcible against the property in the hands not only of the original contractor, but of his heirs, administrators, executors, voluntary assignees and purchasers or encumbrancers with notice.' 3 *Pomeroy's Equity Jurisprudence*, Sec. 1235.

"'It is well settled that an agreement to charge, or to assign, or to give security upon, or to affect property not yet in existence * * * or property to be acquired by him in the future * * * does constitute an equitable lien upon the property so existing or acquired at a subsequent time, which is enforced in the same manner and against the same parties as a lien upon specific things existing and owned by the contracting party at the date of the contract.' 3 *Pomeroy's Equity Jurisprudence*, Sec. 1236."

In *Klaustermeyer v. Cleveland Trust Co., Assignee*, 89 O. S. 142, 105 N. E. 278 (1913) Klaustermeyer, a director in The Euclid Avenue Trust Company, agreed with others to loan the bank $5,000 upon the condition that each of them should be given security for the loan from certain collateral securities owned by and in possession of the bank. The loan was made but Klaustermeyer neither received any securities as collateral nor were any securities segregated for him by the bank. The bank subsequently made an assignment for the benefit of creditors and in holding that Klaustermeyer had an equitable lien on the assets of the bank, the Supreme Court of Ohio said at page 147:

"Now, one of the fundamental maxims of equity is, '*equity regards as done that which ought to be done.*'

"'The broad meaning of this maxim is that where an obligation rests upon a person to perform an act equity will treat the person in whose favor the act should be performed as clothed with the same interest

and entitled to the same rights as if the act were actually performed. It is closely connected with and probably derived from the principle of regarding intent and substance rather than form. * * * The principle also lends its force to the establishment of liens and charges which could not be sustained at law, and to working out justice by fixing *rights as of the time when the obligation first accrued*, rather than according to circumstances subsequently arising.' 16 *Cyc.* 135." (Italics the court's.)

In *Barnes v. Alexander*, 232 U. S. 117 (1914), Barnes was employed as an attorney upon a contingent fee of one-fourth and promised Alexander and Street one-third of this one-fourth if they would handle the case. The Court held that this promise created a lien upon the fund the moment it was received by Barnes. See also *New York Trust Co. v. Michigan Traction Co.*, 193 Fed. 175 (Dist. Ct. Mich., 1912).

An equitable charge or interest having been created by the provisions of the contract in favor of the debenture holders to the extent of 10% of the net earnings of the taxpayer during the taxable year, such debenture holders as equitable incumbrancers had an equitable lien upon such percentage of earnings. (*Restatement of the Law of Trusts*, Vol. 1, section 10 (a).) And since the Trustee had a right to enforce such obligation and lien, must it not be said that the contract required as a matter of law that such percentage of earnings be irrevocably set aside within the taxable year? Implied conditions in a contract are as effective as express conditions once they are established and the corporation with a written contract containing implied conditions is certainly as entitled to a credit as a corporation having a contract with express conditions.[1] The action of the Board of Directors of taxpayer on December 14, 1936, in adopting the resolution authorizing the

[1] Section 26 (c) (2) only requires that the provisions of the contract *expressly* deal with the disposition of earnings and profits of the taxable year.

officers specifically to meet the requirements of the Indenture and of Section 26 (c) (2) of the Act by irrevocably surrendering to the Trustee the necessary amount of debentures, is a clear and unequivocal recognition by the taxpayer that its debenture holders had acquired an equitable lien during the taxable year upon 10% of its net earnings and constituted compliance with the requirement of the contract that such amount be irrevocably set aside within the taxable year. The taxpayer herein was manifestly under a fiduciary duty to irrevocably set aside 10% of its net earnings and to make it clear that it had done so it paid the estimated requirements within the taxable year, and if in so doing it did more than it was required by the contract, it still comes within the statute since a part of what it did—the inevitable "drawing on current earnings, thus removing current earnings as a source of dividend payments"[1]—it was required to do by the contract. It must also be remembered as this Court has already said in *Helvering v. Northwest Steel Rolling Mills, Inc.*, 311 U. S. 46 (1940) "* * * the surtax is imposed upon the annual net income *only if it is not distributed*, * * *." (Emphasis ours).

D. An analysis of Section 26 (c) (2), the conditions it imposes, and decided cases.

1. Introductory statement.

Section 26 (c) (2) imposes the following conditions:

(1) That there be a written contract executed by the corporation prior to May 1, 1936.

(2) That there be a provision which expressly deals with the disposition of earnings and profits of the taxable year—

(3) (a) To be paid within the taxable year *in* discharge of a debt; or

[1] *G. B. R. Oil Corporation v. Commissioner*, 40 B. T. A. 738 (1939).

(b) To be irrevocably set aside within the taxable year *for* the discharge of a debt.

(4) A requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits.

(5) When the above conditions are met a credit may be given to the extent that such an amount has been paid or set aside.

The Commissioner by Brief (p. 14) concedes the existence of (1) and (2), leaving the issue confined to a consideration of the remaining conditions. And as heretofore urged we believe the phrase "within the taxable year" in (3) should be construed in such a manner as to give effect to the percentage provision contained in (4). There is no question but that the deposit of bonds of December 16, 1936, effected a compliance with (5). The sum under consideration herein has been subject to a normal tax and was distributed within the taxable year. The broad issue is whether they are now subject to a further tax as "undistributed" in spite of the fact that they have been distributed pursuant to the provisions of the contract which removed them as a source of dividend payment.

2. In interpreting the credit provisions of Section 26 (c) (2) of the Revenue Act of 1936, the Board of Tax Appeals has reaffirmed the principles announced in its decision in Strong Manufacturing Company.

Section 26 (c) (2) early came up for decision in *G. B. R. Oil Corporation v. Commissioner*, 40 B. T. A. 738 (1939), in which the taxpayer corporation borrowed money from a bank to use in the purchase of oil leaseholds. The bank was secured by deed of trust liens on the properties and also by assignments of the taxpayer's interests in the properties in trust, which assignments authorized the bank to receive and collect all sums of money derived from the properties and to apply the same on the indebtedness to

the bank. The bank credited the payments it received from the taxpayer's oil customers to the taxpayer's account, with an understanding that out of the funds deposited nothing would be paid of any character whatever except the actual, necessary and usual operating expenses, and the balance would be applied to the reduction of the loan. The taxpayer's claim for a credit under Section 26 (c) (2) of the Revenue Act of 1936 for all of the amounts paid to the bank in 1936 under this arrangement was allowed by the Board, which said in part at page 744:

> "The general purpose of section 26 (c) (2), it seems to us, is to give a credit where a dividend paid credit can not be secured. In other words, the basic intent of Congress seems to have been to include in the provision only contracts which inevitably require in their performance a drawing on current earnings, thus removing current earnings as a source of dividend payments. See *Paul and Mertens*, par. 32 A. 46, 1938, cumulative supplement."[1]

The application of Section 26 (c) (2) next arose in *Michigan Silica Company v. Commissioner*, 41 B. T. A. 511 (1940) where the taxpayer was engaged in the production and sale of sand and was required by contract to pay to a trustee under a bond indenture the sum of 25 cents per ton for sand sold. The taxpayer made a payment in January 1937 for the sand produced and sold in December 1936.

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[1] In *Chesapeake Ferry Company v. Early, Jr., Collector* (Memo. Op.), 39—2 U. S. T. C. Sec. 9786, p. 10,923 (Dist. Ct. Va., 1939) the court at first denied a credit claimed under Section 26 (c) (2) of the Revenue Act of 1936 for sinking fund payments made under a deed of trust. However, after the *G. B. R. Oil Corporation* case, *supra*, had been decided, the court filed an "Additional Memorandum" saying in part (p. 10,924):

> "Upon rehearing and reconsideration and in the light of the Board's decision (in the *G. B. R. Oil* case) above quoted, I am of the opinion that the provisions of the deed of trust in question 'inevitably require in their performance a drawing on current earnings, thus removing current earnings as a source of dividend payments,' and that petitioner is entitled to the relief sought."

In allowing this payment as a credit in the determination of the 1936 tax the Board said at page 515:

> "Since it would be impossible to compute any monthly payment due the sinking fund here until after the close of the month, the contested credit shall include the payment for sand sold during December of the taxable year, 1936, even though that payment was not physically made until January 1937. This seems proper on the theory that such payment was made *as of* December, 1936." (Italics the Board's.)

In *Strong Manufacturing Co. v. Commissioner*, 41 B. T. A. 1273 (1940) (now pending in this Court to review a judgment of the Circuit Court of Appeals for the Sixth Circuit, *Helvering v. Strong Manufacturing Co.*, 124 F. (2d) 360 (1941)), the contract required the taxpayer to apply 40% of its net earnings for any calendar year in discharge of the debt, settlement to be made not later than April 15 of the succeeding year. The Board allowed the credit under Section 26 (c) (2), stating on page 511;

> "On this record, compliance with these conditions is questionable only in one respect. There was a written contract executed prior to May 1, 1936, containing a provision expressly dealing with the disposition of earnings and profits for the taxable year. The credit claimed is for an amount equal to the portion of such earnings and profits required to be paid in discharge of a debt, and this amount was paid in the taxable year. The sole remaining condition is that such portion of the earnings and profits be required by the contract to be paid or irrevocably set aside within the taxable year. We are of the opinion that the 'application' to the indebtedness of the designated portion of the earnings may, for present purposes, be considered to be called for by the contract 'as of' the taxable year, *Michigan Silica Co.*, 41 B. T. A. 511, 515, and, therefore, to constitute the irrevocable setting aside contemplated by the statute. The credit should have been allowed and respondent's determination to the contrary is overruled."

Subsequent to its decision in the *Strong* case the Board has decided a number of cases involving the application of Section 26 (c) (2) of the 1936 Act but an examination of such shows that although in many cases it has denied credits under different facts, it has adhered to the principles laid down in the *Strong* case and followed in *The Ohio Leather* and *Warren Tool Corporation* cases. In so doing, however, it has constantly applied the principles of *New Colonial Ice Co. v. Helvering*, 292 U. S. 435,—that in order to avail itself of a deduction the taxpayer must carry the burden of establishing that it comes within the precise language of the statute but in so doing it has adhered to its reasoning in the decisions now on review before this Court.

Of the recent Board cases the one nearest in point to the case at bar is *Baltimore Steam Packet Co.*, 44 B. T. A. 629 (1941). The taxpayer in that case was indebted to three banks and on July 31, 1935, renewed its loans for one year by a written agreement including the following provision:

> "That effective January 1, 1936, any Net Income after deductions for depreciation (as the term 'Net Income' is now defined in the accounting regulations and reports of the Interstate Commerce Commission) of the Company from its operations, as reported in its annual reports to the Interstate Commerce Commission, accruing during the life of said loans (by the three banks) * * * to this company, shall be applied to the pro rata reduction of said loans * * *." (Page 630.)

On August 1, 1936 this contract and the three notes were extended and renewed for another year, with minor modifications.

About the middle of December of 1936 the taxpayer estimated its net earnings for 1936 would be about $25,000.00 and paid this amount to the banks. Upon final determination made after the close of the year it was as-

certained that actual net earnings amounted to $25,490.23. On March 13, 1937, it paid the remaining $490.23 to the three banks.

The Board was of the opinion that the entire $25,490.23 was a proper credit under Section 26 (c) (2). On authority of its decisions in *G. B. R. Oil Corporation*, 40 B. T. A.; *Michigan Silica Co.*; and *Joell Co.*, 41 B. T. A. 825, the Board held that the above provision, relating to net income "expressly deals with the disposition of earnings and profits of the taxable year," as it is required by Section 26 (c) (2). Continuing the Board said:

> "There is nothing in the opinion of the Supreme Court in *Helvering v. Northwest Steel Rolling Mills, Inc. supra* (311 U. S. 46) which supports respondent's contention. In that case the Supreme Court held that a corporation which was prohibited by state law from distributing as dividends its profits of the taxable year because of a previously existing deficit was not entitled to a credit under section 26 (c) (1). The Court stated that a provision of the corporation's charter, that it should obey state law, including the statutory prohibition against distributing dividends, was not a provision of a written contract executed by the corporation and thus did not meet the requirements of section 26 (c) (1). The Court's general statement, 'that provisions granting special tax exemptions are to be strictly construed,' does not compel the conclusion in the present case that the provision in question did not deal expressly with the earnings and profits of the taxable year." (Pages 633-4.)

The Commissioner also contended that provision did not require the earnings and profits "to be paid within the taxable year" or "to be irrevocably set aside within the taxable year" and cited *Moloney Electric Co.* and *Northwest Steel Mills*. In answer to this the Board cited and discussed fully *Strong Mfg. Co.* and *Michigan Silica* (requiring payment "as of" the taxable year "and therefore to constitute the irrevocable setting aside contemplated

by the statute"). Then dealing with the *Moloney* case the Board said:

> "*Moloney Electric Co., supra*, which is cited by respondent in his brief, is distinguishable. In that case, under a provision of a trust agreement securing its bonds, the taxpayer was required to pay to the trustee as a sinking fund on the first day of June of every year, as long as the bonds were outstanding, 20 per cent of its net earnings for the next preceding year in excess of $320,000. The Board held that this provision of the trust agreement did not require a portion of the taxpayer's earnings and profits of the taxable year to be paid or irrevocably set aside within the taxable year and that the taxpayer was not entitled to a credit under section 26 (c) (2) with respect to this provision of the trust agreement. The Board distinguished the *Strong Manufacturing Co.* case on the ground that in the *Strong* case 'the taxpayer recognized that under its contract its creditor had an equitable lien, during the taxable year, upon 40 per cent of its net earnings' while in the *Moloney* case 'the creditor had no equitable lien upon (taxpayer's) earnings until and unless they should be in excess of $320,000.'
>
> "It should be pointed out that the record in the present case clearly indicates that petitioner recognized that under the provision in question the three banks had an equitable lien during the taxable year upon its net income (after deduction for depreciation) of that year. The testimony of petitioner's general auditor indicates that petitioner understood that its net income of the taxable year 'belonged to' the three banks; that the three banks had 'an equitable lien' on its net income of the taxable year; and that it was obligated to pay its net income of the taxable year to the three banks at the end of that year. In accordance with this understanding petitioner, about the middle of December of the taxable year, estimated that its net income of the taxable year would be approximately $25,000 and on December 23 of the taxable year paid a total of $25,000 to the three banks. Its net income of the taxable year, as finally determined after the close

of that year, amounted to $25,490.23; and on March 13, 1937, it paid the balance of $490.23 to the three banks.

* * * * *

"Under section 26 (c) (2) the credit allowable is limited to the amount which was actually paid or irrevocably set aside within the taxable year under the provision in question. Petitioner paid to the three banks a total of $25,000 on December 23, 1936, and a total of $490.23 on March 13, 1937, under the provision in question. The payment of $490.23 may be considered as made 'as of' the taxable year. *Michigan Silica Co., supra.* Respondent makes no issue as to the amount of the credit allowable." (Page 636.)

3. There is no real conflict of opinion within the Federal Courts nor was error reached herein by the Circuit Court of Appeals for the Sixth Circuit.

The Commissioner has cited in his brief the cases of *Helvering v. Moloney Electric Co.*, 120 F. (2d) 617 (C. C. A. 8) and *Antietam Hotel Corp. v. Commissioner*, 123 F. (2d) 274 (C. C. A. 4) in support of his contention that the contract in the instant case does not satisfy the requirements of Section 26 (c) (2). It is submitted, however, that the difference is one of facts and that there is no real conflict between the decision in the *Strong Manufacturing Company* case and the cases so cited.

In *Helvering v. Moloney Electric Company*, 120 F. (2d) 617 (C. C. A. 8th, June 9, 1941) the court reviewed the decision of the Board of Tax Appeals in *Moloney Electric Company*, 42 B. T. A. 78. The taxpayer claimed two credits under Section 26 (c) (2) of the Revenue Act of 1936 because of its alleged compliance with the provisions of a trust indenture, the applicable parts of which were:

"Section 1. The Company covenants that as a sinking fund for the retirement of debenture bonds issued hereunder it will pay to the Trustee on the first day of June, 1930, and the first day of each succeeding June thereafter, so long as any of the debenture bonds here-

by authorized are outstanding, a sum equal to 2% of the largest amount of debenture bonds at any time outstanding, and will also pay on said date to the said Trustee 20% of the net earnings, for the next preceding year, as hereinafter defined, of the Company in excess of Three Hundred Twenty Thousand Dollars ($320,000). The determination of the sum to be paid to the sinking fund from the net earnings shall be made from an audit to be made at the close of each calendar year by a firm of certified public accountants acceptable to the Trustee, and when said net earnings are so determined from said audit, which, in no event, shall be later than the first day of each April, *said amount shall forthwith be set aside in a separate fund* by the Company and shall be paid to the Trustee as herein provided on the first day of June of each year, beginning in the year 1930.

* * * * *

"Section 3. The Company may, at its option, at any time redeem all or any part of the debenture bonds then outstanding hereunder. Such redemption shall be upon thirty (30) days' published notice as hereinabove provided, and at the price of One Hundred and Three Dollars ($103.00), and accrued interest to date of redemption, for each debenture bond." (Emphasis ours.)

One credit claimed was for $13,810.00, being 2% of $690,500.00, the largest amount of the bonds outstanding during the taxable year 1936. The other credit claimed was for $31,526.66 being 20% of the net earnings for 1936 in excess of $320,000.00. The 2% credit was allowed by the Board but disallowed by the Circuit Court of Appeals on the ground that the duty to make the payment did not depend upon the presence of earnings in the taxable year.

The taxpayer some time during 1936 retired all of the outstanding bonds and it claimed that in view of the provisions of the trust agreement requiring it to pay the trustee on June 1 of each year 20% of the net earnings of the company for the preceding year in excess of $320,000.00 it was entitled to a credit of 20% of the excess earnings. Both the

Board and the Court of Appeals denied the taxpayer this credit.

The Board of Tax Appeals distinguished its decision in the *Strong Manufacturing Co.* case by saying:

> "The instant proceeding is distinguishable upon its facts from *Strong Manufacturing Co.*, 41 B. T. A. 1273. In the cited case it was found that 'compliance with * * *' (the) conditions' of the statute was questionable in only one respect. It was held that 'the "application" of the designated portion of the earnings and profits required by the contract' was 'to be considered as operative "as of" the taxable year and therefore as the irrevocable setting aside contemplated by the statute.' The contract in that case required the taxpayer to 'apply forty percent (40%) of its net earnings * * * upon the unpaid balance of said purchase price.' The findings show that 'since it appeared (in October of 1936) that petitioner's profits would be such that 40 percent thereof would be in excess of the amount required to discharge the mortgage in full, it was decided to make the payment at that time.' In other words, the taxpayer recognized that under its contract its creditor had an equitable lien, during the taxable year, upon 40 percent of its net earnings. But in the instant proceeding the creditor had no equitable lien upon petitioner's earnings until and unless they should be in excess of $320,000. It has been pointed out above that the evidence is not sufficient to establish this fact; and without it the rationale of *Strong Manufacturing Co.* can not be applied. It is therefore held that the Commissioner did not err in denying petitioner's claim for a credit of $31,526.66 under section 26 (c) (2) *supra.*" 42 B. T. A. at 86, 87.

The Court sustained the Board in its determination that the 20% credit should not be allowed on two grounds: (1) under the terms of the taxpayer's contract it was not required to set aside the 20% of the 1936 excess net earnings until April 1937; and (2) there was no evidence to show whether the payment was made in consideration of the year's earnings and it seemed obvious that the payment

was made under Section 3 of Article III permitting the company at its option to redeem the bonds. The Court's language on these two points at pages 621-2 is as follows:

> "One of the circumstances upon which the right to a credit under Section 26 (c) (2) is conditioned is as stated, that the written contract contain a provision which 'expressly deals with the disposition of earnings and profits of the taxable year.' Another condition imposed by that section is that the payment or setting aside for which credit is claimed must be one which is required to be made within the taxable year. The statute speaks of 'an amount * * * which is required * * * to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt.' *Under the terms of the taxpayer's contract, however, it is clear that the payment or setting aside of 20 percent of the 1936 excess earnings was not required until 1937, the year following the taxable year.* The taxpayer below admitted that payment was not required until June 1, 1937, but urged that the contract 'did require the company to irrevocably set aside within the taxable year 20% of the net earning in excess of $320,000.' It is clear, however, that no irrevocable setting aside was required to be made in 1936 or earlier than April of the succeeding year. The contract requires that when the net earnings are determined from the audit (which is 'to be made at the close of each calendar year'), 'which, in no event, shall be later than the first day of April, *said amount shall forthwith be set aside in a separate fund.*' It follows therefore that one of the terms of the statute has not been met.
>
> "The taxpayer's claim to a credit of $31,526.66 under Section 26 (c) (2) must be denied for an additional reason, which was stated by the Board of Tax Appeals as follows: 'There is no evidence upon which to base a conclusion that any portion of the amount paid in 1936 was paid because of petitioner's obligation to apply 20 percent of its net earnings in excess of $320,000 toward the reduction of its indebtedness. *The record does not disclose whether the payment was made near the close of the year when it was apparent*

that the earnings would be in excess of $320,000 or whether it was made earlier in the year when the earnings were much less than that amount. It seems to be obvious that the payment was made under the option contained in section 3 of article III rather than because of any requirement of the contract that it be made. In any event, in the absence of any showing as to when the payment was made and in the absence of any showing as to the amount of net earnings at that time, it is impossible to find that the payment was made because of the requirement that 20 percent of the net earnings in excess of $320,000 be applied upon the debt."

"For the foregoing reasons, it appears that the Board of Tax Appeals did not err in denying the taxpayer a credit of $31,526.66 under Section 26 (c) (2) of the Revenue Act of 1936."[1] (Emphasis ours.)

Likewise in the *Antietam* case the Court was confronted with entirely different facts and the issue decided in the *Strong* case was never present in the *Antietam* case. The most that can be said about the latter case is that if the Fourth Circuit Court of Appeals *had had to pass* on the question it would have denied the credit. That the taxpayer in the *Antietam* case was in fact in no position to obtain the credit under the principles of the *Strong* case is shown by difference in the facts, a situation recognized by the Board of Tax Appeals[2] for, in denying the credit in the *Antietam* case, it first pointed out that the funds were never segregated during the taxable years but remained in the general bank account. *The credit by the statute is limited "to the extent that such amount has been so paid or set aside."* The Board in the *Antietam* case said:

"We have considered the general question involved in the instant proceeding in two recent opinions. In *Strong Mfg. Co.*, 41 B. T. A. 1273 (Dec. 11, 122), where-

[1] Certiorari was denied by this Court in the *Moloney* case November 10, 1941; rehearing denied January 12, 1942.

[2] Memorandum opinion entered October 23, 1940 and reported C. C. H. Board of Tax Appeals Service, 11,357-A.

in the taxpayer was granted a credit, it appears that the company anticipated its income for the taxable year and actually did make the payments within the taxable year there in question. *Therein the facts differ materially from our instant case.*

"In June of 1940 this Board decided the case of *Moloney Electric Co.*, 42 B. T. A. 78 (Dec. 11, 214), which considered a similar question. In this later case we found against the taxpayer. We said that in the *Strong* case the creditors had an equitable lien throughout the entire taxable year recognized by the taxpayer, whereas in the *Moloney* case the creditor had no equitable lien upon the taxpayer's earnings unless and until they should be in excess of $320,000. While there was a payment of certain moneys within the taxable year by the taxpayer in the *Moloney* case, we said:

> The record does not disclose whether the payment was made near the close of the year when it was apparent that the earnings would be in excess of $320,000, or whether it was made earlier in the year when the earnings were much less than that amount.

"In our instant case (i.e. the *Antietam* case), although the petitioner insists that the bondholders had an equitable lien, the contract expressly provides that they were entitled to nothing provided the net profits, calculated according to the indenture, did not exceed $10,000. Consequently, we have a situation analogous to that of the *Moloney* case with the exception that in our present case nothing was physically transferred within the taxable year. Our lien, if such it be, is closely comparable to the lien of that case. There the Board, although recognizing that a lien may have existed at some time, nevertheless, denied the taxpayer a credit. We must here follow the holding of the *Moloney* case. * * * Furthermore, a stronger factor is here present which was not discussed in the *Moloney* case. There was no actual payment here within the taxable year, nor any visible setting aside of funds. Therefore, it can not be said that all of the requirements of the statute have been fulfilled.

"For the above reasons we must hold in favor of the respondent.

"Decision will be entered under Rule 50." C. C. H. Board of Tax Appeals Service, Dec. 11, 357-A, p. 33,150.

In its opinion the court said:

"Petitioner contends very strenuously that the applicable law of Maryland treats this indenture as an express trust, and that, accordingly, the funds covered by the indenture cannot be diverted from the ultimate use set out in the indenture without the violation of a duty under the trust. Consequently, petitioner claims that there was in this case an irrevocable setting aside of the funds by operation of law. *It is clear from the record, however, that these funds were never actually segregated* from the taxpayer's other moneys during the taxable years in question. Indeed, the evidence discloses that during the taxable years in question, *the funds actually remained in petitioner's general bank account, and it is quite clear that actual payments to the Trustee were not made during the taxable years* but were, in each instance, paid by check during March of the year after the taxable year. Thus, *there was no definitive act within the taxable year which divested the corporation's control over the funds.*" (Emphasis ours.) (123 F. (2d) 274, 276.)

After the Court quoted Regulations 94, Art. 26 (c) (2) set out in full in the Appendix, the Court said:

"Thus, it will be noted that the Treasury Regulation restricts the credit to amounts *actually* set aside within the taxable year. Although such an interpretation is not binding on this Court, it is highly persuasive at least." (Emphasis the Court's.) (123 F. (2d) 274, 277.)

In view of the foregoing, we respectfully urge that there is no conflict between the *Strong* case and the *Antietam* case for the issue decided in the *Strong* case was never present in the *Antietam* case, since in the *Antietam* case there had been no actual setting aside within the tax-

able year as required by the statute and it therefore was no concern of the Fourth Circuit whether or not the statute makes it mandatory that the contract require *in terms* the setting aside within the taxable year. The expression of the Court in the *Strong* case that it did not reach the "same conclusion" as the Fourth Circuit in the *Antietam* case was accordingly dictum since under the facts the Fourth Circuit had no need in its disposition of the case to reach "a conclusion" on this point.

CONCLUSION.

In conclusion it is respectfully submitted that taxpayer is entitled to a credit of $20,949.30 in computing the surtax on its undistributed 1936 profits because:

(1) Taxpayer was under a fiduciary duty to irrevocably set aside such amount within the taxable year, as security for the debenture holders who had acquired an equitable lien enforceable in equity by specific performance; that by reason thereof taxpayer was required by written contract to irrevocably set aside such amount within the taxable year for the discharge of a debt incurred prior to April 30, 1936, said amount being 10% of its earnings and profits for such taxable year which had been so set aside and actually paid within the taxable year, and

(2) the legislative proceedings which eventually resulted in the enactment of Section 26 (c) (2) show an intent on the part of Congress to permit a credit in the instant case where an amount equal to a percentage of earnings and profits is required by written contract to be irrevocably set aside within the taxable year, although the time of payment is postponed until a date subsequent thereto when the amount of the percentage of such earnings can be definitely determined.

For the reasons above stated, we respectfully submit that the judgment of the Circuit Court of Appeals for the Sixth Circuit should be affirmed.

Respectfully submitted,

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APPENDIX.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends*—

* * * * *

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of

the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 26-2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written con-

tract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal

mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

* * * * *